It's a very good time to be a money launderer, and you can thank cryptocurrencies

Saheli Roy Choudhury | Published 5:18 AM ET Fri, 4 Aug 2017
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Cryptocurrencies have exploded in popularity in recent years that has led to a red-hot fundraising trend where start-ups bring in millions of dollars in capital by issuing virtual tokens to investors in exchange for money.

Initial coin offerings (ICOs) have become a primary means of fundraising for projects built on blockchain technology. Companies create and issue digital tokens that can be used to pay for goods and services on their platform or stashed away as an investment. They put out whitepapers describing the platform, software or product they're trying to build, and then people buy those tokens using widely-accepted cryptocurrencies (like bitcoin and ethereum) or fiat currencies like the U.S. dollar.

regulators — and members of the financial industry — worried about the potential of widespread money laundering and fraud.

All told, start-ups have raised more than a billion dollars this year in coin sales and in recent months, just four crypto projects have raised over $660 million combined, according to Smith + Crown, a blockchain research and consulting group.

Digital currencies are pseudonymous, decentralized and encrypted, making it harder to track each of the transactions made, and the individuals behind them. Theoretically, anyone with an internet connection and a digital wallet can be part of a coin sale event. That, many worry, leaves plenty of room for people to launder money or finance terrorism activities and engage in other fraudulent behaviors — especially in countries where corruption is rampant.

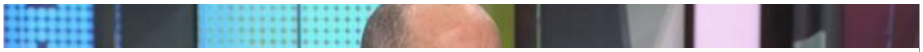
Breeding fraud and money laundering

Regulators in the United States and Singapore have in recent weeks highlighted the risks of money laundering and fraud that investors face when buying into a digital token sale.

On August 1, Singapore's financial regulatory body and central bank, the Monetary Authority of Singapore (MAS), said in a missive that ICOs are "vulnerable to money laundering and terrorist financing risks due to the anonymous nature of the transactions, and the ease with which large sums of monies may be raise in a short period of time."

Meanwhile, the U.S. Securities and Exchange Commission (SEC) provides guidelines on its website for investors to consider before participating in token sales. Some of the key points the SEC asks potential buyers to consider are ways to identify fraudulent investment schemes.

While terrorism financing is not as prevalent in Asia Pacific as compared to the Middle East or North Africa, experts told CNBC that money laundering through cryptocurrencies is a major concern among authorities.



The risks of raising funds via cryptocurrencies

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"It is an anonymous platform and you can get involved, get engaged, transfer value ... you can do all those sorts of things without ever having to identify yourself," Tim Phillipps, APAC leader for Deloitte's Financial Crime Strategy and Response Center, told CNBC.

Traditional anti-money laundering framework requires fund-raising companies to do their due diligence in areas like knowing the customer, validation of their identity and tracking their sources of wealth, according to Phillipps, who previously worked with regulator Australian Securities and Investments Commission.

The regulatory framework also requires companies to structure their products — a process that can sometimes be expensive.

Phillipps said ICOs and cryptocurrencies are just new avenues for an age-old problem: "People would endlessly look for ways to avoid having to go through all the regulatory efforts, the compliance and so on."

How money laundering can happen through ICOs

Although regulators may be expressing concern about money laundering, a frequent refrain from bitcoin enthusiasts and cryptocurrency stakeholders is that the blockchain system is actually inconvenient for would-be launderers.

That is, every transaction of a blockchain-based token is permanently recorded on a publicly view-able digital ledger. Although the parties associated with each exchange are hidden behind pseudonymous IDs, it is possible for investigators to track down who has done what if their activities go through a cooperating exchange.

The concern, experts told CNBC, is that the massive influx of ICOs has meant there are now hundreds of blockchains on which criminals could transact. Concurrently, there's been a proliferation of exchanges that may be less inclined to cooperate with authorities.

vehicle for launderers, and here's roughly how it could work.

- Innocent Bob buys into an ICO of Token$$$ because he hopes it will appreciate
- Bob could either sell his supply of Token$$$ on a major exchange (which is spending money to record customers' information to be compliant for regulators), or he could go to a fly-by-night exchange where the prices are better
- The prices are better on that second exchange because would-be money launderers are willing to pay a premium to wash their funds
- Dirty Harry, who is looking to make his dirty money appear clean, buys Token$$$ from Bob
- Bob makes more money than he would have at a more regulator-friendly exchange, and Harry now has Token$$$ that isn't tied to a criminal enterprise
- Harry can then go to any exchange and sell his Token$$$ for common digital or fiat currencies

Alternately, criminals could just buy into an ICO themselves, hoping that the fledgling technology does not have robust know-your-customer practices.

Although it is feasible that investigators could end up tracking these connections down, the cryptocurrency environment is beneficial to criminals because transactions are incredibly fast-moving compared to the traditional financial system. Furthermore, new companies and exchanges are popping up (and shutting down) faster than governments can track.

Having rules can protect buyers

To prevent money laundering and protect investors from fraud, many argue that cryptocurrencies need some form of regulation — particularly digital coins that sometimes act like securities but are not subjected to any of the stringent mainstream regulations.

Late last month, the Securities and Exchange Commission released an investigative report in which it said companies that planned to use distributed ledger or blockchain-enabled ways to raise capital must take appropriate steps to comply with the U.S. federal securities laws.

digital tokens in the city-state if they constitute products regulated under Singapore's securities and futures regulation.

Having regulatory oversight for ICOs will see net benefits, multiple sources told CNBC. Most agreed that having proper rules in place can protect investors in the same manner they are safeguarded in the securities market.

"Regulators are there to protect investors at the end of the day," Zennon Kapron, founder and director at consultancy firm Kapronasia, told CNBC. "The reason we have regulations around initial public offerings or any kind of securities in any market is to ensure that the process and the operation of (these offerings) are run in an organized and stable fashion."

Having the proper regulation in place is particularly important as this form of fundraising is expected to gain more traction, especially among retail investors. Smith + Crown data showed that in the first half of 2017, there were more token sales than there were in all of 2016, with fundraising amounts increasing month to month since March. Token Data, another website that tracks upcoming token sales, listed dozens of ICOs in the coming months.

Manuel Romano | NurPhoto | Getty Images

A view of Bitcoin token.

Kapron explained that, currently, in order to invest into ICOs, people need to have a certain amount of technical understanding and interest in the space. It's needed to buy ethereum or bitcoin and then invest into

investors, he said regulations will come in handy when it becomes easier to invest in ICOs and thus more people will become involved without necessarily being aware of the risk or challenges behind some of the platforms.

A common criticism leveled at token sales is that many of the start-ups doing it lack either experience or a proper, viable business model. In other words, there's a greater likelihood of the business failing and investors being unable to recover their money. By contrast, in venture capital fundraising rounds, investors scrutinize the viability of a start-up's business plan an its executive strategies before backing them. VC-backed founders are obligated to answer to their investors.

"Tokens are non-dilutive, (usually) possess no voting power, and have very little, if any, rights attached to them. They are neither debt, which enjoys mandatory repayment in the event of a default, nor are they equity, which grants the holder some preferential rights vis-a-vis ordinary shareholders," Justin Hall, principal at early-stage venture capital firm Golden Gate Ventures, told CNBC.

Regulations may undermine cryptocurrencies

Some may argue that regulation could reduce or remove layers of privacy, going against one of the central tenets of crytocurrencies, according to Hall.

"In their mind, fiat currency is corrupted by the heavy-handed intervention of central governments and banks. Cryptocurrencies are anonymous (to a certain extent) and decentralized, meaning decisions affecting the currency are not centrally dictated," he said. "In fiat, trust is enforced by a third-party."

On the other hand, critics would call back to investor protection to argue in favor of regulations, he said, adding it may be difficult to reconcile the two sides. Moreover, Hall said, given how new the technology is, many regulators still "do not fully understand this emerging industry."

Implementing poorly planned policies may do more harm than good, he said.

cryptocurrencies. MAS had issued a notice as early as March 2014 that said virtual currencies were not per se regulated, but intermediaries in virtual currencies would be regulated for money laundering and terrorism financing risks.

"Even though participating in an ICO might be forbidden to Americans or Singaporeans, there is nothing stopping them from purchasing those tokens on a public exchange — and doing so with a fair amount of anonymity to boot."

-Justin Hall, Principal at Golden Gate Ventures

There's also a general misconception among investors and companies that ICOs are not regulated already, according to David Tee, chief financial officer at Hong Kong-based fintech firm ANX International. As a result, he said, many of the ICO campaigns are being done with little or no professional or technical guidance. That likely results in misleading information and unfair sales processes, inappropriately designed token features and poorly written smart contracts that are vulnerable to hacking.

That all, of course, raises the question of why someone would be interested in buying into a poorly-considered ICO in the first place. For most, the answer is simple: They think there's money to be made.

Tee, who is a banking industry veteran, explained to CNBC that digital tokens are a "representation of contractual rights in the form of an easily transferable medium." He said those rights could allow for a variety of things, "or they may be rights to exchange the token for another asset, to receive future payments, or to share in revenues or profits of a venture."

If the rights associated with the tokens fall in the latter category, most jurisdictions would consider them a security, "irrespective of whether that right is in the form of a digital token, a written contract or a formal security such as a share or debt instrument," Tee said.

Currently, to get around regulatory scrutiny, many ICOs prevent residents from the United States and Singapore to participate in their token sales — either by blocking internet protocol addresses from those locations or by relying on self-declarations from the participants. But

using a virtual private network connection to mask their location or by simply asking a third party in a different place to participate on their behalf.

"Even though participating in an ICO might be forbidden to Americans or Singaporeans, there is nothing stopping them from purchasing those tokens on a public exchange — and doing so with a fair amount of anonymity to boot," said Golden Gate Ventures' Hall.

Regulation may be the key to more legitimacy

While regulation can sometimes be expensive for companies, it could also bring in benefits.

Currently, token sales are restricted mostly to retail investors who are not bogged down by the compliance rules faced by institutional investors. A regulated ICO market, with proper checks in place, could draw in professional investors, Syed Musheer Ahmed, a senior financial technology consultant and a member of the board at the FinTech Association of Hong Kong, told CNBC.

If the industry opens up to professional investors, who have more capital to invest, companies can raise more money, he said.

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"Regulatory clarity would result in token sales being conducted in a more professional manner and better disclosure and transparency for the entire process," said Tee. He added that regulation would also "reinforce the need for sellers to have appropriate anti-money

campaign.

Meanwhile, Justin Bailey, CEO of crowdfunded video games publisher Fig, added that regulators like the SEC need to "come to town and bring legitimacy to this technology."

"Digital tokens are certainly having their Wild West moment and the uncertainty of the cryptocurrency market has invited a number of early adopters who are bad actors ... (regulation) will create needed stability and let real innovators further develop tokens and blockchain technology to the benefit of consumers," he said.

Bailey's company has developed an SEC-qualified security, Fig Game Shares, that allows non-accredited investors to financially support video game development and publishing. Each series of **Fig Game Shares** generates returns from the sales of an individual video game title.

—CNBC's Everett Rosenfeld and Ari Levy contributed to this report.

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